Internal Revenue Service
memorandum

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to: District Counsel, Dallas SW:DAL
Attention: Kenneth L. Bressler

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This responds to your request for Tax Litigation Advice with respect to the above-captioned case, which involves the net income limitation (NIL) on petitioner's windfall profit tax (WPT) liability for calendar year [redacted].

ISSUE

Whether an integrated oil company, in calculating the net income limitation for purposes of the windfall profit tax, is required to treat all intangible drilling and development costs (IDC) that it incurred as if capitalized and recovered through cost depletion pursuant to Treas. Reg. § 51.4988-2 or is permitted to deduct the ratable portion of the IDC that are amortized under I.R.C. § 291(b) and to treat the remaining IDC as capitalized for purposes of the hypothetical cost depletion calculation. 1/

CONCLUSION

The relevant Code provisions are clear that the costs which an integrated oil company is required to amortize pursuant to I.R.C. § 291(b) are not "section 263(c) costs" as that term is defined in I.R.C. § 4988(b)(3)(D). Accordingly, an integrated oil company is not required to include such costs in the basis used for hypothetical cost depletion under I.R.C. § 4988(b)(3) and may take a deduction of the ratable amount allowable under I.R.C. § 291(b)(2) from gross income from the property in determining its NIL for WPT purposes.

1/ References are to the Internal Revenue Code as it existed during 1985.

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FACTS

During calendar year [redacted], the petitioner in this case was an integrated oil company within the meaning of I.R.C. § 291(b)(4). Accordingly, where petitioner elected to deduct its IDC pursuant to I.R.C. § 263(c), I.R.C. § 291(b) required petitioner to amortize 20 percent of its IDC over a 36-month period in lieu of taking a current deduction for that percentage. In determining the NIL on its WPT liability for [redacted], petitioner did not include the amounts amortized under I.R.C. § 291(b)(2) in the depletable basis used for calculation of the hypothetical cost depletion deduction. In addition, petitioner took a deduction from gross equal to the ratable amount allowable under I.R.C. § 291(b)(2) for [redacted].

Upon audit, the revenue agent determined that petitioner's approach was incorrect, concluding that petitioner should have treated all amounts amortized under I.R.C. § 291(b) as if they were capitalized and recovered through cost depletion pursuant to Treas. Reg. § 51.4988-2. Using petitioner's [redacted] production and reserve statistics, the agent's approach resulted in a [redacted] year period for cost depletion.

Although this case involves only [redacted], your memorandum indicates that this issue is also raised in other years that are not yet docketed.

DISCUSSION

Applicable Law

I.R.C. § 4986(a) imposes an excise tax on the windfall profit from taxable crude oil removed from the premises during each taxable period. 2/ The "windfall profit" is the excess of the removal price of the barrel of crude over the sum of the adjusted base price and the severance tax adjustment. § 4988(a).

I.R.C. § 4988(b)(1) provides that the windfall profit on any barrel of crude oil shall not exceed 90 percent of the net income attributable to such barrel. The formula for calculating the net income attributable to a barrel of crude

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2/ The WPT applied to taxable crude oil removed from the premises after February 28, 1980, but was repealed by the Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 1941, 102 Stat. 1107, 1322-24 (1988), with respect to crude oil removed on or after August 23, 1988. Thus, all crude oil removed during 1985 was subject to the tax.

oil is prescribed in I.R.C. § 4988(b)(2) as the quotient of (A) the taxable income from the property for the taxable year attributable to taxable crude oil divided by (B) the number of barrels of taxable crude oil from the property taken into account for the taxable year.

Pursuant to I.R.C. § 4988(b)(3)(A), taxable income from the property is determined under I.R.C. § 613(a), except as otherwise provided. 3/ Under Treas. Reg. § 1.613-5(a), taxable income from the property is generally equal to the gross income from the property, as defined in I.R.C. § 613(c) and Treas. Reg. §§ 1.613-3 and 1.613-4, less all allowable deductions (excluding any deduction for depletion) attributable to mining processes with respect to which depletion is claimed.

For WPT purposes, I.R.C. § 4988(b)(3)(B) provides that no deduction is allowed for either depletion or section 263(c) costs in determining taxable income from the property. In lieu of such deductions, I.R.C. § 4988(b)(3)(C) prescribes a deduction for so-called hypothetical cost depletion, defined as follows:

> the cost depletion that would have been allowable for the taxable year with respect to the property if --
>
> (i) all --
> (I) section 263(c) costs . . .
>
> incurred by the taxpayer had been capitalized and taken into account in computing cost depletion, and
>
> (ii) cost depletion had been used by the taxpayer with respect to such property for all taxable years.

The term "section 263(c) costs" is defined in I.R.C. § 4988(b)(3)(D) to mean IDC incurred by the taxpayer which (by reason of an election under section 263(c)) may be deducted as

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3/ I.R.C. § 613(a) allows percentage depletion based on the gross income from the property in the case of mines, wells and other specified natural deposits. The allowance for percentage depletion is limited to 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). I.R.C. § 613(a). The rules for determining taxable income from the property are set forth in Treas. Reg. § 1.613-5.

expenses, but the term does not include costs incurred in drilling a nonproductive well.

I.R.C. § 263(c) provides for regulations granting the option to capitalize or deduct IDC incurred in the development of oil and gas properties. 4/ By its own terms, however, section 263(c) does not apply "with respect to any costs to which any deduction is allowed under section 58(i) or 291."

Under I.R.C. § 291(b)(1)(A), the amount allowable as a deduction to an integrated oil company under section 263(c) is reduced by 20 percent. 5/ Pursuant to I.R.C. § 291(b)(2), the amount not allowable as a deduction under section 263(c) for any taxable year by reason of section 291(b)(1) is allowable as a deduction ratably over the 36-month period beginning with the month in which the costs are paid or incurred. 6/ In addition, I.R.C. § 291(b)(6) provides that the portion of the adjusted basis of any property which is attributable to amounts required to be amortized under I.R.C. § 291(b)(1) shall not be taken into account for purposes of determining depletion under I.R.C. § 611.

Analysis

As an integrated oil company, petitioner in this case was required by section 291(b) to reduce its IDC deduction under section 263(c) by 20 percent on its income tax return for [redacted]. At the same time, I.R.C. § 291(b)(2) allowed petitioner to amortize over 36 months the amount excluded from its IDC deduction.

In determining the NIL on its WPT return for [redacted], petitioner included in the hypothetical cost depletion calculation the amount actually deducted as IDC under section 263(c) but did not include any of the amount subject to section 291(b). Rather than include the section 291(b) amount in the basis for hypothetical cost depletion, petitioner treated the ratable amount allowable for [redacted] as a deduction from the gross income from the property.

4/ Treas. Reg. § 1.612-4 sets forth the option prescribed in I.R.C. § 263(c).

5/ The Tax Reform Act of 1986 increased the amount of the reduction to 30 percent for IDC incurred after December 31, 1986, in taxable years ending after that date.

6/ The 1986 Act increased recovery period from 36 months to 60 months.

The District Director rejected petitioner's treatment of the section 291(b) costs for the NIL calculation on the ground that all IDC, including the IDC amortized under section 291(b), must be treated as if capitalized and recovered through hypothetical cost depletion. In the District Director's view, Congress did not intend the enactment of section 291(b) in 1982 to provide integrated oil companies with a benefit in determining their NIL for WPT purposes. 7/ In support of that position, the Revenue Agent's Report (RAR) cites (1) passages in the committee reports for the WPT Act referring to the hypothetical cost depletion of all IDC and (2) the lack of any discussion of WPT in the legislative history of section 291(b).

Notwithstanding the analysis set forth in the RAR, we believe that petitioner's treatment of its section 291(b) costs is clearly supported by the relevant Code provisions. Section 4988(b)(3) and Treas. Reg. § 4988-2(b) refer to "section 263(c) costs" rather than to IDC in enumerating the deductions that are not allowed in determining taxable income from the property and prescribing the hypothetical cost depletion calculation. The expression "section 263(c) costs" is defined in I.R.C. § 4988(b)(3)(D) as IDC "which (by reason of an election under section 263(c)) may be deducted as expenses for purposes of this title."

When Congress enacted the WPT in 1980, integrated oil companies, as well as all other taxpayers, were allowed to deduct 100 percent of their IDC if they so elected under I.R.C. § 263(c). In 1982, however, Congress added section 291(b) and also amended section 263(c) to provide that section 263(c) "shall not apply with respect to any costs to which any deduction is allowed under section . . . 291." This provision expressly excludes from section 263(c) the IDC required to be amortized under section 291(b). Thus, it is clear that the term "section 263(c) costs," which is defined in I.R.C. § 4988(b)(3)(D) to mean IDC which may be deducted by reason of an election under 263(c), does not include any IDC which an integrated oil company must amortize pursuant to section 291(b).

Furthermore, under section 291(b)(6), the amount amortized pursuant to section 291(b) is expressly excluded from the basis used for cost depletion under section 611. Thus, the amortized amount, which is not included in "section 263(c) costs," would not otherwise be included in the basis used for hypothetical cost depletion.

7/ I.R.C. § 291(b) was enacted in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, § 204.

We recognize that the committee reports for the WPT act cited in the RAR indicate Congress's understanding that taxpayers would include all of their IDC in the basis used for the hypothetical cost depletion. Because section 291(b) was added subsequently, however, we believe that the Tax Court would likely view the WPT committee reports as simply a reflection of section 263(c) as it existed in 1980. The court would thus probably conclude that the statements in those reports were superseded by the clear language of the subsequently enacted provisions.

The RAR correctly notes that there is no indication of congressional intent in the 1982 legislation concerning the effect of section 291 on the hypothetical cost depletion calculation. We do not interpret such silence to mean that Congress necessarily intended to continue requiring integrated oil companies to include 100 percent of their IDC in the basis used for hypothetical cost depletion. The failure to mention WPT may mean either that Congress did not consider the effect of section 291 on hypothetical cost depletion or that Congress viewed the effects of the 1982 legislation to be so obvious that no comment was needed. We believe that, in the absence of any indication to the contrary, the Tax Court would interpret Congress's silence to mean that Congress intended for taxpayers to apply the unambiguous relevant Code provisions, as amended by the 1982 legislation, in calculating their NIL for WPT purposes.

Although this result may give integrated oil companies a benefit for WPT purposes, we do not believe that, without any explicit evidence to the contrary, the Tax Court would likely conclude that Congress did not intend such a benefit. As the taxpayer pointed out, the same treatment would be available to any individual taxpayer that elected to amortize its IDC over a ten year period pursuant to I.R.C. § 58(i). 8/ As is the case for section 291(b) costs, section 263(c) is explicitly inapplicable to costs for which a deduction is allowed under section 58(i). Therefore, an individual taxpayer electing to amortize a portion of his IDC would not include the amortized amount in the hypothetical cost depletion calculation and could deduct from gross income from the property the ratable amount allowed under section 58(i).

In short, while we recognize the District Director's concerns about the proper calculation of petitioner's NIL for WPT purposes, we have concluded that petitioner has correctly

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8/ As a result of amendments since 1982, the election is now contained in I.R.C. § 59(e).

interpreted the relevant Code provisions. We believe that those provisions are clear and unambiguous and, further, that there is no indication that Congress intended a different result.

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If you have any questions, please contact Jerry Fleming at FTS 566-3345.

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